

The Honorable Ricardo S. Martinez

UNITED STATES DISTRICT COURT  
WESTERN DISTRICT OF WASHINGTON  
AT SEATTLE

UNITED STATES OF AMERICA,

Petitioner,

v.

MICROSOFT CORPORATION,

Respondent.

No. 2:14-mc-00117-RSM

DECLARATION OF MICHAEL J.  
BERNARD IN SUPPORT OF MOTION  
FOR STATUS CONFERENCE

I, Michael J. Bernard, pursuant to 28 U.S.C. § 1746, declare as follows:

1. I am Microsoft's U.S. Tax Counsel and have served in that capacity since the early 1990s. I have been involved in the Internal Revenue Service ("IRS") audit of Microsoft's taxable years ended December 31, 2004, 2005, and 2006, which are at issue in this case, and I have personal knowledge of the matters set forth herein.

2. Microsoft has not been served with the Government's Petition to Enforce Internal Revenue Service Summons. Rather, we learned of its filing through news reports published on December 15, 2014.

3. The summons dated October 30, 2014 (the "Summons") is not a typical summons under 26 U.S.C. § 7602, but is alleged to be a "designated summons" as described in 26 U.S.C. § 6503(j). The Petition fails to disclose that, during the 30 days after the

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1 Summons was issued, the IRS issued an additional eighteen allegedly "related summonses"  
2 within the meaning of 26 U.S.C. § 6503(j)(1)(A)(ii) to Microsoft, KPMG LLP ("KPMG"),  
3 Ernst and Young LLP (E&Y), and current or former Microsoft, KPMG, and EY employees.

4 4. The IRS's audit of Microsoft's 2004-2006 taxable years began in January 2007,  
5 nearly eight years ago. Microsoft has cooperated throughout the audit, producing  
6 approximately 1.2 million pages of documents and making over 50 employees available for  
7 interviews, in response to 220 Information Document Requests ("IDRs") issued by the IRS.  
8 No summonses were issued to Microsoft before October 30, 2014.

9 5. On May 3, 2011, over three and one-half years ago, the IRS concluded the  
10 2004-2006 field audit and issued a thirty-day letter, a revenue agent's report, and an external  
11 economist's report determining the IRS's proposed values for the buy-in royalties required to  
12 be paid by foreign participants as arm's length consideration to Microsoft under 26 U.S.C. §  
13 482 for pre-existing intangibles made available by Microsoft in two cost sharing  
14 arrangements. These cost sharing arrangements covered the production and distribution of  
15 software products in certain Asian and Pacific markets and Western Hemisphere markets (the  
16 "APAC Cost Sharing Arrangement" and the "Americas Cost Sharing Arrangement,"  
17 respectively).

18 6. In response to the thirty-day letter, Microsoft filed a protest brief on June 29,  
19 2011. Microsoft's protest would normally have resulted in the IRS Examination Division's  
20 forwarding this dispute to the IRS Appeals Division, which has the authority to settle tax  
21 disputes on behalf of the IRS.  
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1           7.       The IRS did not allow the dispute to proceed to the IRS Appeals Division.  
2       Instead, the Director of Transfer Pricing Operations ("TPO") within the IRS Large Business  
3       & International Examination Division asked for six months to conduct additional field work  
4       for the purpose of developing a secondary or alternative buy-in value and a transfer pricing  
5       adjustment with respect to the Americas Cost Sharing Arrangement. The six-month extended  
6       audit has gone on now for three years. The IRS engaged over a half dozen additional external  
7       experts in economics, finance, software technology, marketing, and the software industry.  
8       They produced an economic model, expert reports, and oral advice to the IRS in support of an  
9       alternative buy-in valuation and transfer pricing adjustment with respect to the Americas Cost  
10      Sharing Arrangement. The IRS presented its alternative buy-in/pricing model, two supporting  
11      expert reports, and a summary of the experts' oral advice to Microsoft in a meeting on January  
12      14, 2014.  
13

14           8.       Throughout the extended audit Microsoft repeatedly expressed its desire that,  
15      once the IRS completed its secondary valuation, the case move to the IRS Appeals Division  
16      for settlement negotiations. At the January 2014 presentation, the TPO asked us to enter into  
17      direct settlement negotiations before the case would be sent to the IRS Appeals Division.  
18      After some preliminary discussions, we declined to negotiate with the TPO, because the TPO  
19      wanted to limit such discussions to agreeing upon modifications to the secondary valuation  
20      model without any discussion of the parties' respective litigation hazards under 26 U.S.C. §  
21      482, the regulations thereunder, and the decided case law.  
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23           9.       On May 19, 2014, unbeknownst to Microsoft at that time, the IRS engaged the  
24      law firm of Quinn Emanuel Urquhart & Sullivan, LLP ("Quinn Emanuel"). The TPO  
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1 disclosed Quinn Emanuel's involvement in a letter dated August 28, 2014. In September,  
2 2014, the IRS gave us a copy of the Performance Work Statement from the government  
3 contract, which described the engagement of Quinn Emanuel as "an expert in commercial  
4 litigation (the 'Contractor') to assist with the evaluation, analysis, presentation and defense of  
5 claims or adjustments related to the issues under examination."  
6

7 10. On June 14, 2014, less than one month after the IRS engaged Quinn Emanuel,  
8 the Treasury Department issued in proposed and temporary form an amended regulation, 26  
9 C.F.R. § 301.7602-1(T)(b)(1).

10 11. During the summer of 2014, the TPO advised us, for the first time, that the IRS  
11 was considering whether to "designate for litigation" the Microsoft case pursuant to Internal  
12 Revenue Manual ("IRM") Part 33.3.6. Under IRM Part 33.3.6.1(2), designating a case for  
13 litigation bars the IRS Appeals Division from settling the case other than by the taxpayer's  
14 100% concession of the designated issue. The TPO advised Microsoft that it would decide  
15 whether to seek designation after taking 32 depositions in September and October 2014.  
16

17 12. Following these depositions, the IRS did not advise us whether it would  
18 designate the case for litigation. Instead, on October 30, 2014, it issued the Summons that is  
19 at issue here. The Summons states 48 separate document requests. Many of these requests are  
20 new requests and seek documents not previously requested in IDRs. The IRS set a response  
21 date of November 20, 2014, and refused to extend the response date. We responded to the  
22 Summons on November 20, 2014, and we currently are conducting due diligence to ascertain  
23 whether there are additional documents responsive to these requests.  
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Executed on this 18th day of December, 2014.

MICHAEL J. BERNARD

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**CERTIFICATE OF SERVICE**

I hereby certify under penalty of perjury that on December 18, 2014, I electronically filed the foregoing with the Clerk of the Court using the CM/ECF system, which will send notification of such filing to all parties.

s/ Robert B. Mitchell

Robert B. Mitchell  
K&L GATES LLP

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